

1ST SOURCE CORP  
Form 10-Q  
April 24, 2014  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q  
(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-6233

(Exact name of registrant as specified in its charter)

INDIANA

35-1068133

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

100 North Michigan Street

South Bend, IN

46601

(Address of principal executive offices)

(Zip Code)

(574) 235-2000

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
 Yes  No

Number of shares of common stock outstanding as of April 18, 2014 — 24,334,787 shares

---

Table of Contents

## TABLE OF CONTENTS

	Page
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (Unaudited)</u>	
<u>Consolidated Statements of Financial Condition — March 31, 2014 and December 31, 2013</u>	<u>3</u>
<u>Consolidated Statements of Income — three months ended March 31, 2014 and 2013</u>	<u>4</u>
<u>Consolidated Statements of Comprehensive Income — three months ended March 31, 2014 and 2013</u>	<u>5</u>
<u>Consolidated Statements of Shareholders' Equity — three months ended March 31, 2014 and 2013</u>	<u>5</u>
<u>Consolidated Statements of Cash Flows — three months ended March 31, 2014 and 2013</u>	<u>6</u>
<u>Notes to the Consolidated Financial Statements</u>	<u>7</u>
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>29</u>
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>36</u>
<u>Item 4. Controls and Procedures</u>	<u>36</u>
<u>PART II. OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	<u>36</u>
<u>Item 1A. Risk Factors</u>	<u>36</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>36</u>
<u>Item 3. Defaults Upon Senior Securities</u>	<u>36</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>37</u>
<u>Item 5. Other Information</u>	<u>37</u>
<u>Item 6. Exhibits</u>	<u>37</u>
<u>SIGNATURES</u>	<u>38</u>
<u>CERTIFICATIONS</u>	
<u>Exhibit 31.1</u>	<u>39</u>
<u>Exhibit 31.2</u>	<u>40</u>
<u>Exhibit 32.1</u>	<u>41</u>
<u>Exhibit 32.2</u>	<u>42</u>

Table of Contents

1st SOURCE CORPORATION  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION  
(Unaudited - Dollars in thousands)

	March 31, 2014	December 31, 2013
<b>ASSETS</b>		
Cash and due from banks	\$92,465	\$77,568
Federal funds sold and interest bearing deposits with other banks	1,362	2,484
Investment securities available-for-sale (amortized cost of \$826,007 and \$822,163 at March 31, 2014 and December 31, 2013, respectively)	839,597	832,700
Other investments	22,400	22,400
Trading account securities	192	192
Mortgages held for sale	10,961	6,079
Loans and leases, net of unearned discount:		
Commercial and agricultural loans	698,246	679,492
Auto and light truck	388,665	391,649
Medium and heavy duty truck	237,906	237,854
Aircraft financing	730,803	738,133
Construction equipment financing	352,796	333,088
Commercial real estate	588,629	583,997
Residential real estate	455,678	460,981
Consumer loans	124,845	124,130
Total loans and leases	3,577,568	3,549,324
Reserve for loan and lease losses	(85,010)	(83,505)
Net loans and leases	3,492,558	3,465,819
Equipment owned under operating leases, net	58,468	60,967
Net premises and equipment	45,856	46,630
Goodwill and intangible assets	86,057	86,343
Accrued income and other assets	123,277	121,644
Total assets	\$4,773,193	\$4,722,826
<b>LIABILITIES</b>		
Deposits:		
Noninterest bearing	\$750,662	\$735,212
Interest bearing	2,957,761	2,918,438
Total deposits	3,708,423	3,653,650
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	168,339	181,120
Other short-term borrowings	129,308	133,011
Total short-term borrowings	297,647	314,131
Long-term debt and mandatorily redeemable securities	59,555	58,335
Subordinated notes	58,764	58,764
Accrued expenses and other liabilities	52,218	52,568
Total liabilities	4,176,607	4,137,448
<b>SHAREHOLDERS' EQUITY</b>		

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Preferred stock; no par value		
Authorized 10,000,000 shares; none issued or outstanding	—	—
Common stock; no par value		
Authorized 40,000,000 shares; issued 25,641,887 at March 31, 2014 and December 31, 2013	346,535	346,535
Retained earnings	270,848	261,626
Cost of common stock in treasury (1,306,006 shares at March 31, 2014 and 1,319,377 shares at December 31, 2013)	(29,285	) (29,364 )
Accumulated other comprehensive income	8,488	6,581
Total shareholders' equity	596,586	585,378
Total liabilities and shareholders' equity	\$4,773,193	\$4,722,826

The accompanying notes are a part of the consolidated financial statements.

3

---

Table of Contents

1st SOURCE CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited - Dollars in thousands, except per share amounts)

	Three Months Ended March 31,	
	2014	2013
Interest income:		
Loans and leases	\$38,914	\$39,170
Investment securities, taxable	3,345	3,695
Investment securities, tax-exempt	819	771
Other	277	242
Total interest income	43,355	43,878
Interest expense:		
Deposits	2,971	4,542
Short-term borrowings	136	32
Subordinated notes	1,055	1,055
Long-term debt and mandatorily redeemable securities	575	495
Total interest expense	4,737	6,124
Net interest income	38,618	37,754
Provision for loan and lease losses	804	757
Net interest income after provision for loan and lease losses	37,814	36,997
Noninterest income:		
Trust fees	4,476	4,101
Service charges on deposit accounts	2,066	2,239
Debit card income	2,232	2,065
Mortgage banking income	1,334	1,628
Insurance commissions	1,563	1,446
Equipment rental income	4,082	4,012
Gains on investment securities available-for-sale	963	—
Other income	2,682	3,457
Total noninterest income	19,398	18,948
Noninterest expense:		
Salaries and employee benefits	19,482	19,936
Net occupancy expense	2,437	2,207
Furniture and equipment expense	4,237	3,899
Depreciation - leased equipment	3,249	3,225
Professional fees	1,128	1,355
Supplies and communication	1,392	1,536
FDIC and other insurance	864	878
Business development and marketing expense	1,684	773
Loan and lease collection and repossession expense	(494)	) 757
Other expense	1,994	1,984
Total noninterest expense	35,973	36,550
Income before income taxes	21,239	19,395

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Income tax expense	7,607	6,991
Net income	\$13,632	\$12,404
Per common share:		
Basic net income per common share	\$0.55	\$0.50
Diluted net income per common share	\$0.55	\$0.50
Dividends	\$0.17	\$0.17
Basic weighted average common shares outstanding	24,317,446	24,321,985
Diluted weighted average common shares outstanding	24,317,446	24,324,328
The accompanying notes are a part of the consolidated financial statements.		

4

---

Table of Contents

1st SOURCE CORPORATION  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited - Dollars in thousands)

	Three Months Ended March 31,	
	2014	2013
Net income	\$ 13,632	\$ 12,404
Other comprehensive income (loss):		
Change in unrealized appreciation (depreciation) of available-for-sale securities	4,016	(1,931 )
Reclassification adjustment for realized (gains) losses included in net income	(963 )	—
Income tax effect	(1,146 )	725
Other comprehensive income (loss), net of tax	1,907	(1,206 )
Comprehensive income	\$ 15,539	\$ 11,198

The accompanying notes are a part of the consolidated financial statements.

1st SOURCE CORPORATION  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
(Unaudited - Dollars in thousands, except per share amounts)

	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net	Total
Balance at January 1, 2013	\$—	\$346,535	\$223,715	\$(31,134 )	\$ 19,539	\$558,655
Net income	—	—	12,404	—	—	12,404
Other comprehensive loss	—	—	—	—	(1,206 )	(1,206 )
Issuance of 148,627 common shares under stock based compensation awards, including related tax effects	—	—	(281 )	3,530	—	3,249
Cost of 24,800 shares of common stock acquired for treasury	—	—	—	(566 )	—	(566 )
Common stock dividend (\$0.17 per share)	—	—	(4,174 )	—	—	(4,174 )
Balance at March 31, 2013	\$—	\$346,535	\$231,664	\$(28,170 )	\$ 18,333	\$568,362
Balance at January 1, 2014	\$—	\$346,535	\$261,626	\$(29,364 )	\$ 6,581	\$585,378
Net income	—	—	13,632	—	—	13,632
Other comprehensive income	—	—	—	—	1,907	1,907
Issuance of 61,978 common shares under stock based compensation awards, including related tax effects	—	—	(243 )	1,480	—	1,237
Cost of 48,607 shares of common stock acquired for treasury	—	—	—	(1,401 )	—	(1,401 )



Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Common stock dividend (\$0.17 per share)	—	—	(4,167	) —	—	(4,167	)
Balance at March 31, 2014	\$—	\$346,535	\$270,848	\$(29,285	) \$ 8,488	\$596,586	

The accompanying notes are a part of the consolidated financial statements.

Table of Contents

1st SOURCE CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited - Dollars in thousands)

	Three Months Ended March 31,	
	2014	2013
Operating activities:		
Net income	\$13,632	\$12,404
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	804	757
Depreciation of premises and equipment	1,189	1,148
Depreciation of equipment owned and leased to others	3,249	3,225
Amortization of investment security premiums and accretion of discounts, net	1,044	942
Amortization of mortgage servicing rights	286	480
Deferred income taxes	(905	) 433
Gains on investment securities available-for-sale	(963	) —
Originations of loans held for sale, net of principal collected	(22,470	) (26,885
Proceeds from the sales of loans held for sale	18,373	28,308
Net gain on sale of loans held for sale	(785	) (1,178
Change in trading account securities	—	(16
Change in interest receivable	(714	) (1,339
Change in interest payable	100	856
Change in other assets	3,433	865
Change in other liabilities	905	(728
Other	1,271	112
Net change in operating activities	18,449	19,384
Investing activities:		
Proceeds from sales of investment securities	1,236	—
Proceeds from maturities of investment securities	64,251	65,273
Purchases of investment securities	(69,412	) (47,367
Loans sold or participated to others	689	8,109
Net change in loans and leases	(33,676	) (54,653
Net change in equipment owned under operating leases	(750	) (4,509
Purchases of premises and equipment	(421	) (1,761
Net change in investing activities	(38,083	) (34,908
Financing activities:		
Net change in demand deposits, NOW accounts and savings accounts	(6,167	) (33,078
Net change in certificates of deposit	60,940	89,297
Net change in short-term borrowings	(16,484	) (54,311
Proceeds from issuance of long-term debt	5,647	4,912
Payments on long-term debt	(6,096	) (9,189
Net proceeds from issuance of treasury stock	1,237	3,249
Acquisition of treasury stock	(1,401	) (566
Cash dividends paid on common stock	(4,267	) (4,267
Net change in financing activities	33,409	(3,953
Net change in cash and cash equivalents	13,775	(19,477

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Cash and cash equivalents, beginning of year	80,052	83,934
Cash and cash equivalents, end of period	\$93,827	\$64,457

Supplemental Information:

Non-cash transactions:

Loans transferred to other real estate and repossessed assets	\$5,444	\$822
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan	—	2,801

The accompanying notes are a part of the consolidated financial statements.

6

---

Table of Contents

1ST SOURCE CORPORATION  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1. Basis of Presentation

1st Source Corporation is a bank holding company headquartered in South Bend, Indiana that provides, through its subsidiaries (collectively referred to as “1st Source” or “the Company”), a broad array of financial products and services. The accompanying unaudited consolidated financial statements reflect all adjustments (all of which are normal and recurring in nature) which are, in the opinion of management, necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in shareholders’ equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been omitted.

The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation’s Annual Report on Form 10-K (2013 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The Consolidated Statement of Financial Condition at December 31, 2013 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the current year presentation.

Note 2. Recent Accounting Pronouncements

Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure: In January 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-04 "Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure." ASU 2014-04 clarifies when an in substance repossession or foreclosure occurs and requires interim and annual disclosures of the amount of foreclosed residential real estate property and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. ASU 2014-04 is effective either on a modified retrospective transition method or a prospective transition method for interim and annual periods beginning after December 15, 2014. Early adoption is permitted. The Company is assessing the impact of ASU 2014-04 on its disclosures.

Accounting for Investments in Qualified Affordable Housing Projects: In January 2014, the FASB issued ASU No. 2014-01 "Investments - Equity method and Joint Ventures (Topic 323) - Accounting for Investments in Qualified Affordable Housing Projects." ASU 2014-01 allows investors to use the proportional amortization method to account for investments in limited liability entities that manage or invest in affordable housing projects that qualify for low-income housing tax credits if certain conditions are met. ASU 2014-01 is effective retrospectively for interim and annual periods in fiscal years that begin after December 15, 2014. Early adoption is permitted. The Company is assessing the impact of ASU 2014-01 on its accounting for affordable housing projects.

Investment Companies: In June 2013, the FASB issued ASU No. 2013-08 “Financial Services-Investment Companies (Topic 946) — Amendments to the Scope, Measurement and Disclosure Requirements.” ASU 2013-08 changes the approach to the investment company assessment in Topic 946, clarifies the characteristics of an investment company and provides comprehensive guidance for assessing whether an entity is an investment company. ASU 2013-08 is effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013. Early application is prohibited. The Company determined that 1st Source Capital Corporation, a wholly-owned subsidiary of 1st Source

Bank, is considered an investment company and is applying the guidance in Topic 946 in accordance with ASU 2013-08.

7

---

Table of Contents

## Note 3. Investment Securities

The following table shows investment securities available-for-sale.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2014				
U.S. Treasury and Federal agencies securities	\$400,973	\$ 4,440	\$ (4,023 )	\$ 401,390
U.S. States and political subdivisions securities	124,174	3,775	(555 )	127,394
Mortgage-backed securities — Federal agencies	266,392	5,395	(2,267 )	269,520
Corporate debt securities	31,875	308	(43 )	32,140
Foreign government and other securities	700	2	—	702
Total debt securities	824,114	13,920	(6,888 )	831,146
Marketable equity securities	1,893	6,560	(2 )	8,451
Total investment securities available-for-sale	\$ 826,007	\$ 20,480	\$ (6,890 )	\$ 839,597
December 31, 2013				
U.S. Treasury and Federal agencies securities	\$394,558	\$ 5,008	\$ (4,527 )	\$ 395,039
U.S. States and political subdivisions securities	120,416	3,670	(847 )	123,239
Mortgage-backed securities — Federal agencies	273,495	5,148	(3,563 )	275,080
Corporate debt securities	30,828	241	(4 )	31,065
Foreign government and other securities	700	9	—	709
Total debt securities	819,997	14,076	(8,941 )	825,132
Marketable equity securities	2,166	5,404	(2 )	7,568
Total investment securities available-for-sale	\$ 822,163	\$ 19,480	\$ (8,943 )	\$ 832,700

At March 31, 2014 and December 31, 2013, the residential mortgage-backed securities held by the Company consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (Government Sponsored Enterprise, GSEs).

The following table shows the contractual maturities of investments in securities available-for-sale at March 31, 2014. Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	Amortized Cost	Fair Value
Due in one year or less	\$37,524	\$38,027
Due after one year through five years	400,315	404,908
Due after five years through ten years	117,501	116,329
Due after ten years	2,382	2,362
Mortgage-backed securities	266,392	269,520
Total debt securities available-for-sale	\$824,114	\$831,146

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

The following table shows the gross realized gains and losses on sale of securities from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses on the sales of all securities are computed using the specific identification cost basis. The gross gains and losses for the three months ended March 31, 2014 reflect the sale of marketable equity securities.

(Dollars in thousands)	Three Months Ended	
	March 31,	
	2014	2013
Gross realized gains	\$963	\$—
Gross realized losses	—	—
Net realized gains (losses)	\$963	\$—

Table of Contents

The following table summarizes gross unrealized losses and fair value by investment category and age.

(Dollars in thousands)	Less than 12 Months		12 months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>March 31, 2014</b>						
U.S. Treasury and Federal agencies securities	\$210,143	\$(3,876 )	\$15,044	\$(147 )	\$225,187	\$(4,023 )
U.S. States and political subdivisions securities	34,278	(528 )	915	(27 )	35,193	(555 )
Mortgage-backed securities - Federal agencies	72,185	(1,438 )	14,813	(829 )	86,998	(2,267 )
Corporate debt securities	6,066	(43 )	—	—	6,066	(43 )
Foreign government and other securities	100	—	—	—	100	—
Total debt securities	322,772	(5,885 )	30,772	(1,003 )	353,544	(6,888 )
Marketable equity securities	—	—	4	(2 )	4	(2 )
Total investment securities available-for-sale	\$322,772	\$(5,885 )	\$30,776	\$(1,005 )	\$353,548	\$(6,890 )
<b>December 31, 2013</b>						
U.S. Treasury and Federal agencies securities	\$153,868	\$(4,404 )	\$15,085	\$(123 )	\$168,953	\$(4,527 )
U.S. States and political subdivisions securities	37,115	(814 )	1,419	(33 )	38,534	(847 )
Mortgage-backed securities - Federal agencies	99,488	(3,099 )	5,352	(464 )	104,840	(3,563 )
Corporate debt securities	6,332	(4 )	—	—	6,332	(4 )
Foreign government and other securities	—	—	—	—	—	—
Total debt securities	296,803	(8,321 )	21,856	(620 )	318,659	(8,941 )
Marketable equity securities	—	—	4	(2 )	4	(2 )
Total investment securities available-for-sale	\$296,803	\$(8,321 )	\$21,860	\$(622 )	\$318,663	\$(8,943 )

The initial indication of OTTI for both debt and equity securities is a decline in fair value below amortized cost. Quarterly, the impaired securities are analyzed on a qualitative and quantitative basis in determining OTTI. Declines in the fair value of available-for-sale debt securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income. In estimating OTTI impairment losses, the Company considers among other things, (i) the length of time and the extent to which fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) whether it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

There were no other-than-temporary-impairment (OTTI) write-downs in 2014 or 2013.

At March 31, 2014, the Company does not have the intent to sell any of the available-for-sale securities in the table above and believes that it is more likely than not, that it will not have to sell any such securities before an anticipated recovery of cost. Primarily the unrealized losses on debt securities are due to increases in market rates over the yields available at the time the underlying securities were purchased and market illiquidity on auction rate securities which are reflected in U.S. States and political subdivisions. The fair value is expected to recover on all debt securities as they approach their maturity date or re-pricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.



At March 31, 2014 and December 31, 2013, investment securities with carrying values of \$248.11 million and \$237.42 million, respectively, were pledged as collateral for security repurchase agreements and for other purposes.

Note 4. Loan and Lease Financings

The Company evaluates loans and leases for credit quality at least annually but more frequently if certain circumstances occur (such as material new information which becomes available and indicates a potential change in credit risk). The Company uses two methods to assess credit risk: loan or lease credit quality grades and credit risk classifications. The purpose of the loan or lease credit quality grade is to document the degree of risk associated with individual credits as well as inform management of the degree of risk in the portfolio taken as a whole. Credit risk classifications are used to categorize loans by degree of risk and to designate individual or committee approval authorities for higher risk credits at the time of origination. Credit risk classifications include categories for: Acceptable, Marginal, Special Attention, Special Risk, Restricted by Policy, Regulated and Prohibited by Law.

Table of Contents

All loans and leases, except residential real estate loans and consumer loans, are assigned credit quality grades on a scale from 1 to 12 with grade 1 representing superior credit quality. The criteria used to assign grades to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on the Company's safety and soundness. Loans or leases graded 7 or weaker are considered "special attention" credits and, as such, relationships in excess of \$100,000 are reviewed quarterly as part of management's evaluation of the appropriateness of the reserve for loan and lease losses. Grade 7 credits are defined as "watch" and contain greater than average credit risk and are monitored to limit the exposure to increased risk; grade 8 credits are "special mention" and, following regulatory guidelines, are defined as having potential weaknesses that deserve management's close attention. Credits that exhibit well-defined weaknesses and a distinct possibility of loss are considered "classified" and are graded 9 through 12 corresponding to the regulatory definitions of "substandard" (grades 9 and 10) and the more severe "doubtful" (grade 11) and "loss" (grade 12).

The following table shows the credit quality grades of the recorded investment in loans and leases, segregated by class.

(Dollars in thousands)	Credit Quality Grades		
	1-6	7-12	Total
March 31, 2014			
Commercial and agricultural loans	\$671,796	\$26,450	\$698,246
Auto and light truck	379,015	9,650	388,665
Medium and heavy duty truck	233,505	4,401	237,906
Aircraft financing	697,505	33,298	730,803
Construction equipment financing	345,542	7,254	352,796
Commercial real estate	564,365	24,264	588,629
Total	\$2,891,728	\$105,317	\$2,997,045
December 31, 2013			
Commercial and agricultural loans	\$652,620	\$26,872	\$679,492
Auto and light truck	378,392	13,257	391,649
Medium and heavy duty truck	235,465	2,389	237,854
Aircraft financing	704,997	33,136	738,133
Construction equipment financing	325,849	7,239	333,088
Commercial real estate	557,692	26,305	583,997
Total	\$2,855,015	\$109,198	\$2,964,213

For residential real estate and consumer loans, credit quality is based on the aging status of the loan and by payment activity. The following table shows the recorded investment in residential real estate and consumer loans by performing or nonperforming status. Nonperforming loans are those loans which are on nonaccrual status or are 90 days or more past due.

(Dollars in thousands)	Performing	Nonperforming	Total
March 31, 2014			
Residential real estate	\$453,025	\$2,653	\$455,678
Consumer	124,402	443	124,845
Total	\$577,427	\$3,096	\$580,523
December 31, 2013			
Residential real estate	\$458,385	\$2,596	\$460,981
Consumer	123,663	467	124,130

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Total	\$582,048	\$3,063	\$585,111
-------	-----------	---------	-----------

10

---

Table of Contents

The following table shows the recorded investment of loans and leases, segregated by class, with delinquency aging and nonaccrual status.

(Dollars in thousands)	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Accruing Loans	Nonaccrual	Total Financing Receivables
March 31, 2014							
Commercial and agricultural loans	\$686,536	\$200	\$1	\$—	\$ 686,737	\$11,509	\$698,246
Auto and light truck	388,074	241	2	—	388,317	348	388,665
Medium and heavy duty truck	237,762	12	—	—	237,774	132	237,906
Aircraft financing	716,622	7,072	3,528	—	727,222	3,581	730,803
Construction equipment financing	351,206	424	—	—	351,630	1,166	352,796
Commercial real estate	583,474	—	—	—	583,474	5,155	588,629
Residential real estate	452,365	459	201	274	453,299	2,379	455,678
Consumer	123,669	598	135	33	124,435	410	124,845
Total	\$3,539,708	\$9,006	\$3,867	\$307	\$ 3,552,888	\$24,680	\$3,577,568
December 31, 2013							
Commercial and agricultural loans	\$667,462	\$263	\$2	\$—	\$ 667,727	\$11,765	\$679,492
Auto and light truck	387,881	222	36	—	388,139	3,510	391,649
Medium and heavy duty truck	237,645	20	—	—	237,665	189	237,854
Aircraft financing	713,832	10,309	3,627	—	727,768	10,365	738,133
Construction equipment financing	331,083	973	—	—	332,056	1,032	333,088
Commercial real estate	576,933	—	—	—	576,933	7,064	583,997
Residential real estate	456,782	1,334	269	197	458,582	2,399	460,981
Consumer	122,657	786	220	84	123,747	383	124,130
Total	\$3,494,275	\$13,907	\$4,154	\$281	\$ 3,512,617	\$36,707	\$3,549,324

Table of Contents

The following table shows impaired loans and leases, segregated by class, and the corresponding reserve for impaired loan and lease losses.

(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
March 31, 2014			
With no related reserve recorded:			
Commercial and agricultural loans	\$11,146	\$11,146	\$—
Auto and light truck	266	266	—
Medium and heavy duty truck	—	—	—
Aircraft financing	3,650	3,652	—
Construction equipment financing	784	784	—
Commercial real estate	12,789	12,789	—
Residential real estate	—	—	—
Consumer loans	—	—	—
Total with no related reserve recorded	28,635	28,637	—
With a reserve recorded:			
Commercial and agricultural loans	—	—	—
Auto and light truck	—	—	—
Medium and heavy duty truck	—	—	—
Aircraft financing	497	497	57
Construction equipment financing	345	345	9
Commercial real estate	—	—	—
Residential real estate	377	380	160
Consumer loans	—	—	—
Total with a reserve recorded	1,219	1,222	226
Total impaired loans	\$29,854	\$29,859	\$226
December 31, 2013			
With no related reserve recorded:			
Commercial and agricultural loans	\$11,231	\$11,230	\$—
Auto and light truck	3,499	3,499	—
Medium and heavy duty truck	—	—	—
Aircraft financing	9,764	9,764	—
Construction equipment financing	938	938	—
Commercial real estate	14,897	14,897	—
Residential real estate	—	—	—
Consumer loans	—	—	—
Total with no related reserve recorded	40,329	40,328	—
With an allowance recorded:			
Commercial and agricultural loans	—	—	—
Auto and light truck	—	—	—
Medium and heavy duty truck	—	—	—
Aircraft financing	563	563	113
Construction equipment financing	—	—	—
Commercial real estate	—	—	—
Residential real estate	381	381	161
Consumer loans	—	—	—

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Total with a reserve recorded	944	944	274
Total impaired loans	\$41,273	\$41,272	\$274

12

---

Table of Contents

The following table shows average recorded investment and interest income recognized on impaired loans and leases, segregated by class.

(Dollars in thousands)	Three Months Ended March 31, 2014		2013	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural loans	\$11,255	\$16	\$8,319	\$3
Auto and light truck	1,627	—	—	—
Medium and heavy duty truck	—	—	466	—
Aircraft financing	6,976	9	8,268	—
Construction equipment financing	949	—	4,705	2
Commercial real estate	13,666	147	20,545	152
Residential real estate	378	4	—	—
Consumer	—	—	—	—
Total	\$34,851	\$176	\$42,303	\$157

The following table shows the number of loans and leases classified as troubled debt restructuring (TDR) during the three months ended March 31, 2014 and 2013, segregated by class, as well as the recorded investment as of March 31. The classification between nonperforming and performing is shown at the time of modification. During 2014 and 2013, modification programs focused on extending maturity dates or modifying payment patterns with most TDRs experiencing a combination of concessions. The modifications did not result in the contractual forgiveness of principal or interest or interest rate reductions below market rates. Consequently, the financial impact of the modifications is immaterial.

(Dollars in thousands)	Three Months Ended March 31, 2014		2013	
	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
<b>Performing TDRs:</b>				
Commercial and agricultural loans	—	\$ —	—	\$ —
Auto and light truck	—	—	—	—
Medium and heavy duty truck	—	—	—	—
Aircraft financing	1	596	—	—
Construction equipment financing	—	—	—	—
Commercial real estate	—	—	—	—
Residential real estate	—	—	—	—
Consumer	—	—	—	—
Total performing TDR modifications	1	\$ 596	—	\$ —
<b>Nonperforming TDRs:</b>				
Commercial and agricultural loans	—	\$ —	1	\$ 25
Auto and light truck	—	—	—	—
Medium and heavy duty truck	—	—	—	—
Aircraft financing	—	—	—	—
Construction equipment financing	—	—	—	—
Commercial real estate	—	—	—	—
Residential real estate	—	—	—	—

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Consumer	—	—	—	—
Total nonperforming TDR modifications	—	\$ —	1	\$ 25
Total TDR modifications	1	\$ 596	1	\$ 25

There were no TDRs which had payment defaults within the twelve months following modification during the three months ended March 31, 2014 and 2013. Default occurs when a loan or lease is 90 days or more past due under the modified terms or transferred to nonaccrual.



Table of Contents

The following table shows the recorded investment of loans and leases classified as troubled debt restructurings as of March 31, 2014 and December 31, 2013.

(Dollars in thousands)	March 31, 2014	December 31, 2013
Performing TDRs	\$9,331	\$8,786
Nonperforming TDRs	9,434	11,824
Total TDRs	\$18,765	\$20,610

Note 5. Reserve for Loan and Lease Losses

The reserve for loan and lease loss methodology has been consistently applied for several years, with enhancements instituted periodically. Reserve ratios are reviewed quarterly and revised periodically to reflect recent loss history and to incorporate current risks and trends which may not be recognized in historical data. As the historical charge-off analysis is updated, the Company reviews the look-back periods for each business loan portfolio. Furthermore, a thorough analysis of charge-offs, non-performing asset levels, special attention outstandings and delinquency is performed in order to review portfolio trends and other factors, including specific industry risks and economic conditions, which may have an impact on the reserves and reserve ratios applied to various portfolios. The Company adjusts the calculated historical based ratio as a result of the analysis of environmental factors, principally economic risk and concentration risk. Key economic factors affecting the portfolios are growth in gross domestic product, unemployment rates, housing market trends, commodity prices, inflation and global economic and political issues. Concentration risk is impacted primarily by geographic concentration in Northern Indiana and Southwestern Lower Michigan in the business banking and commercial real estate portfolios and by collateral concentration in the specialty finance portfolios and exposure to foreign markets by geographic risk.

The reserve for loan and lease losses is maintained at a level believed to be appropriate by the Company to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant judgment reflecting the Company's best estimate of probable loan and lease losses related to specifically identified impaired loans and leases as well as probable losses in the remainder of the various loan and lease portfolios. For purposes of determining the reserve, the Company has segmented loans and leases into classes based on the associated risk within these segments. The Company has determined that eight classes exist within the loan and lease portfolio. The methodology for assessing the appropriateness of the reserve consists of several key elements, which include: specific reserves for impaired loans, formula reserves for each business lending division portfolio including percentage allocations for special attention loans and leases not deemed impaired, and reserves for pooled homogeneous loans and leases. The Company's evaluation is based upon a continuing review of these portfolios, estimates of customer performance, collateral values and dispositions, and assessments of economic and geopolitical events, all of which are subject to judgment and will change.

Table of Contents

The following table shows the changes in the reserve for loan and lease losses, segregated by class, for the three months ended March 31, 2014 and 2013.

(Dollars in thousands)	Commercial agricultural	Auto and light truck	Medium and heavy duty	Aircraft financing	Construction equipment financing	Commercial real estate	Residential real estate	Consumer loans	Total
<b>March 31, 2014</b>									
Reserve for loan and lease losses									
Balance, beginning of period	\$11,515	\$9,657	\$4,212	\$34,037	\$5,972	\$12,406	\$4,093	\$1,613	\$83,505
Charge-offs	15	11	—	—	2	1	16	258	303
Recoveries	379	234	37	57	166	39	5	87	1,004
Net charge-offs (recoveries)	(364 )	(223 )	(37 )	(57 )	(164 )	(38 )	11	171	(701
Provision (recovery of provision)	(60 )	(224 )	162	415	178	165	(20 )	188	804
Balance, end of period	\$11,819	\$9,656	\$4,411	\$34,509	\$6,314	\$12,609	\$4,062	\$1,630	\$85,010
Ending balance, individually evaluated for impairment	\$—	\$—	\$—	\$57	\$9	\$—	\$160	\$—	\$226
Ending balance, collectively evaluated for impairment	11,819	9,656	4,411	34,452	6,305	12,609	3,902	1,630	84,784
Total reserve for loan and lease losses	\$11,819	\$9,656	\$4,411	\$34,509	\$6,314	\$12,609	\$4,062	\$1,630	\$85,010
<b>Recorded investment in loans</b>									
Ending balance, individually evaluated for impairment	\$11,146	\$266	\$—	\$4,147	\$1,129	\$12,789	\$377	\$—	\$29,854
Ending balance, collectively evaluated for impairment	687,100	388,399	237,906	726,656	351,667	575,840	455,301	124,845	3,547,714
Total recorded investment in loans	\$698,246	\$388,665	\$237,906	\$730,803	\$352,796	\$588,629	\$455,678	\$124,845	\$3,577,568
<b>March 31, 2013</b>									
Reserve for loan and lease losses									
Balance, beginning of period	\$12,326	\$8,864	\$3,721	\$34,205	\$5,390	\$13,778	\$3,652	\$1,375	\$83,311
Charge-offs	285	1	—	31	83	62	77	423	962
Recoveries	109	121	16	178	35	329	6	111	905
Net charge-offs (recoveries)	176	(120 )	(16 )	(147 )	48	(267 )	71	312	57

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Provision (recovery of provision)	1,077	(288	) (264	) (520	) 383	(124	) 125	368	757
Balance, end of period	\$13,227	\$8,696	\$3,473	\$33,832	\$5,725	\$13,921	\$3,706	\$1,431	\$84,011
Ending balance, individually evaluated for impairment	\$434	\$—	\$—	\$1,639	\$—	\$—	\$—	\$—	\$2,073
Ending balance, collectively evaluated for impairment	12,793	8,696	3,473	32,193	5,725	13,921	3,706	1,431	81,938
Total reserve for loan and lease losses	\$13,227	\$8,696	\$3,473	\$33,832	\$5,725	\$13,921	\$3,706	\$1,431	\$84,011
Recorded investment in loans									
Ending balance, individually evaluated for impairment	\$7,072	\$—	\$464	\$14,762	\$4,154	\$20,203	\$—	\$—	\$46,655
Ending balance, collectively evaluated for impairment	640,589	412,569	203,203	684,479	281,762	546,152	445,160	112,649	3,326,563
Total recorded investment in loans	\$647,661	\$412,569	\$203,667	\$699,241	\$285,916	\$566,355	\$445,160	\$112,649	\$3,373,218

Note 6. Mortgage Servicing Assets

The Company recognizes the rights to service residential mortgage loans for others as separate assets, whether the servicing rights are acquired through a separate purchase or through the sale of originated loans with servicing rights retained. The Company allocates a portion of the total proceeds of a mortgage loan to servicing rights based on the relative fair value. The unpaid principal balance of residential mortgage loans serviced for third parties was \$828.02 million and \$839.26 million at March 31, 2014 and December 31, 2013, respectively.

Mortgage servicing assets are evaluated for impairment at each reporting date. For purposes of impairment measurement, mortgage servicing assets are stratified based on the predominant risk characteristics of the underlying servicing, principally by loan type. If temporary impairment exists within a tranche, a valuation allowance is established through a charge to income equal to the amount by which the carrying value exceeds the fair value. If it is later determined all or a portion of the temporary impairment no longer exists for a particular tranche, the valuation allowance is reduced through a recovery of income.

Table of Contents

The following table shows changes in the carrying value of mortgage servicing assets and the associated valuation allowance.

(Dollars in thousands)	Three Months Ended March 31,	
	2014	2013
Mortgage servicing assets:		
Balance at beginning of period	\$4,844	\$4,645
Additions	201	363
Amortization	(286	) (480
Sales	—	—
Carrying value before valuation allowance at end of period	4,759	4,528
Valuation allowance:		
Balance at beginning of period	—	—
Impairment (charges) recoveries	—	—
Balance at end of period	\$—	\$—
Net carrying value of mortgage servicing assets at end of period	\$4,759	\$4,528
Fair value of mortgage servicing assets at end of period	\$7,868	\$6,137

During the three months ended March 31, 2014, the Company determined that it was not necessary to permanently write-down any previously established valuation allowance. At March 31, 2014 and 2013, the fair value of mortgage servicing assets exceeded the carrying value reported in the Statements of Financial Condition by \$3.11 million and \$1.61 million, respectively. This difference represents increases in the fair value of certain mortgage servicing assets that could not be recorded above cost basis.

Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$0.79 million and \$0.82 million for the three months ended March 31, 2014 and 2013, respectively. Mortgage loan contractual servicing fees are included in Mortgage Banking Income on the Statements of Income.

#### Note 7. Commitments and Financial Instruments with Off-Balance-Sheet Risk

1st Source and its subsidiaries are parties to financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate and sell loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Statements of Financial Condition. The exposure to credit loss in the event of nonperformance by the other party to the financial instruments for loan commitments and standby letters of credit is represented by the dollar amount of those instruments. The Company uses the same credit policies and collateral requirements in making commitments and conditional obligations as it does for on-balance-sheet instruments.

1st Source Bank (Bank), a subsidiary of 1st Source Corporation, grants mortgage loan commitments to borrowers, subject to normal loan underwriting standards. The interest rate risk associated with these loan commitments is managed by entering into contracts for future deliveries of loans. Loan commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Bank issues standby letters of credit which are conditional commitments that guarantee the performance of a client to a third party. The credit risk involved in and collateral obtained when issuing standby letters of credit is essentially the same as that involved in extending loan commitments to clients. Standby letters of credit totaled \$19.77

million and \$19.27 million at March 31, 2014 and December 31, 2013, respectively. Standby letters of credit generally have terms ranging from six months to one year.

Note 8. Derivative Financial Instruments

Commitments to originate residential mortgage loans held for sale and forward commitments to sell residential mortgage loans are considered derivative instruments. See Note 7 for further information.

Table of Contents

The Company has certain interest rate derivative positions that are not designated as hedging instruments. Derivative assets and liabilities are recorded at fair value on the balance sheet and do take into account the effects of master netting agreements. Master netting agreements allow the Company to settle all derivative contracts held with a single counterparty on a net basis, and to offset net derivative positions with related collateral, where applicable. These derivative positions relate to transactions in which the Company enters into an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. In connection with each transaction, the Company agrees to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, the Company agrees to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the client to effectively convert a variable rate loan to a fixed rate. Because the terms of the swaps with the customers and the other financial institutions offset each other, with the only difference being counterparty credit risk, changes in the fair value of the underlying derivative contracts are not materially different and do not significantly impact the Company's results of operations.

The following table shows the amounts of non-hedging derivative financial instruments at March 31, 2014 and December 31, 2013.

(Dollars in thousands)	Notional or contractual amount	Asset derivatives	Fair value	Liability derivatives	Fair value
		Statement of Financial Condition classification		Statement of Financial Condition classification	
March 31, 2014					
Interest rate swap contracts	\$465,980	Other assets	\$9,531	Other liabilities	\$9,719
Loan commitments	18,217	Mortgages held for sale	122	N/A	—
Forward contracts - mortgage loan	23,650	Mortgages held for sale	1	N/A	—
Forward contracts - foreign exchange	1,142	N/A	—	Other assets	2
Total	\$508,989		\$9,654		\$9,721
December 31, 2013					
Interest rate swap contracts	\$462,790	Other assets	\$9,894	Other liabilities	\$10,087
Loan commitments	7,878	Mortgages held for sale	12	N/A	—
Forward contracts - mortgage loan	10,600	Mortgages held for sale	121	N/A	—
Forward contracts - foreign exchange	1,308	N/A	—	Other assets	7
Total	\$482,576		\$10,027		\$10,094

The following table shows the amounts included in the Statements of Income for non-hedging derivative financial instruments for the three months ended March 31, 2014 and 2013.

(Dollars in thousands)	Statement of Income classification	Gain (loss)	
		Three Months Ended March 31, 2014	2013

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Interest rate swap contracts	Other expense	\$6	\$30
Interest rate swap contracts	Other income	92	194
Loan commitments	Mortgage banking income	110	44
Forward contracts - mortgage loan	Mortgage banking income	(120)	) 17
Forward contracts - foreign exchange	Other income	(1)	) —
Total		\$87	\$285

17

---

Table of Contents

The following table shows the offsetting of financial assets and derivative assets at March 31, 2014 and December 31, 2013.

(Dollars in thousands)	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Statement of Financial Condition	Net Amounts of Assets Presented in the Statement of Financial Condition	Gross Amounts Not Offset in the Statement of Financial Condition		
				Financial Instruments	Cash Collateral Received	Net Amount
March 31, 2014						
Interest rate swaps	\$ 10,065	\$ 534	\$ 9,531	\$ —	\$ —	\$ 9,531
December 31, 2013						
Interest rate swaps	\$ 10,511	\$ 617	\$ 9,894	\$ —	\$ —	\$ 9,894

The following table shows the offsetting of financial liabilities and derivative liabilities at March 31, 2014 and December 31, 2013.

(Dollars in thousands)	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Statement of Financial Condition	Net Amounts of Liabilities Presented in the Statement of Financial Condition	Gross Amounts Not Offset in the Statement of Financial Condition		
				Financial Instruments	Cash Collateral Pledged	Net Amount
March 31, 2014						
Interest rate swaps	\$ 10,253	\$ 534	\$ 9,719	\$ —	\$ 9,032	\$ 687
Repurchase agreements	124,339	—	124,339	124,339	—	—
Total	\$ 134,592	\$ 534	\$ 134,058	\$ 124,339	\$ 9,032	\$ 687
December 31, 2013						
Interest rate swaps	\$ 10,704	\$ 617	\$ 10,087	\$ —	\$ 8,409	\$ 1,678
Repurchase agreements	117,620	—	117,620	117,620	—	—
Total	\$ 128,324	\$ 617	\$ 127,707	\$ 117,620	\$ 8,409	\$ 1,678

If a default in performance of any obligation of a repurchase agreement occurs, each party will set-off property held in respect of transactions against obligations owing in respect of any other transactions.

#### Note 9. Earnings Per Share

Earnings per common share is computed using the two-class method. Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include non-vested restricted stock awards. Non-vested restricted stock awards are considered participating securities to the extent the holders of these securities receive non-forfeitable dividends at the same rate as holders of common stock. Diluted earnings per common share is computed using the weighted-average number of shares determined for



the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method. Stock options, where the exercise price was greater than the average market price of the common shares, were excluded from the computation of diluted earnings per common share because the result would have been antidilutive. There were no stock options outstanding as of March 31, 2014 and 2013.

Table of Contents

The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share for the three months ended March 31, 2014 and 2013.

(Dollars in thousands - except per share amounts)	Three Months Ended	
	March 31,	
	2014	2013
Distributed earnings allocated to common stock	\$4,135	\$4,143
Undistributed earnings allocated to common stock	9,311	8,101
Net earnings allocated to common stock	13,446	12,244
Net earnings allocated to participating securities	186	160
Net income allocated to common stock and participating securities	\$13,632	\$12,404
Weighted average shares outstanding for basic earnings per common share	24,317,446	24,321,985
Dilutive effect of stock compensation	—	2,343
Weighted average shares outstanding for diluted earnings per common share	24,317,446	24,324,328
Basic earnings per common share	\$0.55	\$0.50
Diluted earnings per common share	\$0.55	\$0.50

## Note 10. Stock Based Compensation

As of March 31, 2014, the Company had four active stock-based employee compensation plans, which are more fully described in Note 16 of the Consolidated Financial Statements in 1st Source's Annual Report on Form 10-K for the year ended December 31, 2013. These plans include three executive stock award plans, namely, the Executive Incentive Plan, the Restricted Stock Award Plan, and the 1998 Performance Compensation Plan; and the Employee Stock Purchase Plan. The 2011 Stock Option Plan was approved by the shareholders on April 21, 2011 but the Company had not made any grants through March 31, 2014.

Stock-based compensation expense for all stock-based compensation awards granted is based on the grant-date fair value. For all awards except stock option awards, the grant date fair value is either the fair market value per share or book value per share (corresponding to the type of stock awarded) as of the grant date. For stock option awards, the grant date fair value is estimated using the Black-Scholes option pricing model. For all awards the Company recognizes these compensation costs only for those shares expected to vest on a straight-line basis over the requisite service period of the award, for which the Company uses the related vesting term. The Company estimates forfeiture rates based on historical employee option exercise and employee termination experience. The Company has identified separate groups of award recipients that exhibit similar option exercise behavior and employee termination experience and have considered them as separate groups in the valuation models and expense estimates.

The stock-based compensation expense recognized in the Statements of Income for the three months ended March 31, 2014 and 2013 was based on awards ultimately expected to vest, and accordingly has been adjusted by the amount of estimated forfeitures. GAAP requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based partially on historical experience.

Total fair value of options vested and expensed was zero for the three months ended March 31, 2014 and 2013. As of March 31, 2014 and 2013 there were no outstanding stock options. There were 7,500 stock options exercised at a weighted average price of \$12.04 during the three months ended March 31, 2013. All shares issued in connection with stock option exercises are issued from available treasury stock.

As of March 31, 2014, there was \$8.13 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 3.48 years.

Table of Contents

## Note 11. Accumulated Other Comprehensive Income

The following table presents reclassifications out of accumulated other comprehensive income related to unrealized gains and losses on available-for-sale securities:

(Dollars in thousands)	Three Months Ended March 31,		Affected Line Item in the Statements of Income
	2014	2013	
Realized gains included in net income	\$963	\$—	Gains on investment securities available-for-sale
	963	—	Income before income taxes
Tax effect	(361	) —	Income tax expense
Net of tax	\$602	\$—	Net income

## Note 12. Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$2.65 million at March 31, 2014 and \$2.62 million at December 31, 2013. Interest and penalties were recognized through the income tax provision. For the three months ended March 31, 2014 and 2013, the Company recognized approximately \$0.02 million and \$0.03 million in interest, net of tax effect, and penalties, respectively. Interest and penalties of approximately \$0.72 million and \$0.69 million were accrued at March 31, 2014 and December 31, 2013, respectively.

Effective January 1, 2014, the Indiana Financial Institutions (IFI) tax rate decreased from 8.5% to 8.0% and will continue to decrease by 0.5% each of the next three years. As a result of the rate change, the Company decreased the carrying value of certain state deferred tax assets. The impact of this change was not material and was recorded in the financial statements during the second quarter of 2013. Additionally, on March 26, 2014, tax rate decreases from 6.5% in 2018 to 4.9% in 2023 were enacted. These further decreases did not have an impact on our deferred taxes and as a result, no amount was recorded in our financial statements for this rate change.

Tax years that remain open and subject to audit include the federal 2010-2013 years and the Indiana 2009-2013 years. The Company does not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

## Note 13. Fair Value Measurements

The Company records certain assets and liabilities at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are also utilized to determine the initial value of certain assets and liabilities, to perform impairment assessments, and for disclosure purposes. The Company uses quoted market prices and observable inputs to the maximum extent possible when measuring fair value. In the absence of quoted market prices, various valuation techniques are utilized to measure fair value. When possible, observable market data for identical or similar financial instruments is used in the valuation. When market data is not available, fair value is determined using valuation models that incorporate management's estimates of the assumptions a market participant would use in pricing the asset or liability.

Fair value measurements are classified within one of three levels based on the observability of the inputs used to determine fair value, as follows:

- Level 1 — The valuation is based on quoted prices in active markets for identical instruments.

Level 2 — The valuation is based on observable inputs such as quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 — The valuation is based on unobservable inputs that are supported by minimal or no market activity and that are significant to the fair value of the instrument. Level 3 valuations are typically performed using pricing models, discounted cash flow methodologies, or similar techniques that incorporate management's own estimates of assumptions that market participants would use in pricing the instrument, or valuations that require significant management judgment or estimation.

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Table of Contents

The Company elected fair value accounting for mortgages held for sale. The Company believes the election for mortgages held for sale (which are economically hedged with free standing derivatives) will reduce certain timing differences and better match changes in the value of these assets with changes in the value of derivatives used as economic hedges for these assets. At March 31, 2014 and December 31, 2013, all mortgages held for sale were carried at fair value.

The following table shows the differences between the fair value carrying amount of mortgages held for sale measured at fair value and the aggregate unpaid principal amount the Company is contractually entitled to receive at maturity on March 31, 2014 and December 31, 2013:

(Dollars in thousands)	Fair value carrying amount	Aggregate unpaid principal	Excess of fair value carrying amount over (under) unpaid principal	
March 31, 2014				
Mortgages held for sale reported at fair value	\$ 10,961	\$ 10,717	\$ 244	(1)
December 31, 2013				
Mortgages held for sale reported at fair value	\$ 6,079	\$ 5,974	\$ 105	(1)

The excess of fair value carrying amount over unpaid principal is included in mortgage banking income and (1) includes changes in fair value at and subsequent to funding and gains and losses on the related loan commitment prior to funding.

#### Financial Instruments on Recurring Basis:

The following is a description of the valuation methodologies used for financial instruments measured at fair value on a recurring basis:

Investment securities available for sale are valued primarily by a third party pricing agent. Prices supplied by the independent pricing agent, as well as their pricing methodologies and assumptions, are reviewed by the Company for reasonableness and to ensure such prices are aligned with market levels. In general, the Company's investment securities do not possess a complex structure that could introduce greater valuation risk. The portfolio mainly consists of traditional investments including U.S. Treasury and Federal agencies securities, federal agency mortgage pass-through securities, and general obligation and revenue municipal bonds. Pricing for such instruments is fairly generic and is easily obtained. On a quarterly basis, prices supplied by the pricing agent are validated by comparison to prices obtained from other third party sources for a material portion of the portfolio.

The valuation policy and procedures for Level 3 fair value measurements of available for sale debt securities are decided through collaboration between management of the Corporate Accounting and Funds Management departments. The changes in fair value measurement for Level 3 securities are analyzed on a periodic basis under a collaborative framework with the aforementioned departments. The methodology and variables used for input are derived from the combination of observable and unobservable inputs. The unobservable inputs are determined through internal assumptions that may vary from period to period due to external factors, such as market movement and credit rating adjustments.

Both the market and income valuation approaches are implemented using the following types of inputs:

U.S. treasuries are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.

Government-sponsored agency debt securities and corporate bonds are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.

Other government-sponsored agency securities, mortgage-backed securities and some of the actively traded REMICs and CMOs, are primarily priced using available market information including benchmark yields, prepayment speeds, spreads and volatility of similar securities.

Other inactive government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.

Table of Contents

State and political subdivisions are largely grouped by characteristics, i.e., geographical data and source of revenue in trade dissemination systems. Since some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities. Local direct placement municipal securities, with very little market activity, are priced using an appropriate market yield curve.

Marketable equity (common) securities are primarily priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.

Trading account securities are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.

Mortgages held for sale and the related loan commitments and forward contracts (hedges) are valued using a market value approach and utilizing an appropriate current market yield and a loan commitment closing rate based on historical analysis.

Interest rate swap positions, both assets and liabilities, are valued by a third party pricing agent using an income approach and utilizing models that use as their basis readily observable market parameters. This valuation process considers various factors including interest rate yield curves, time value and volatility factors. Validation of third party agent valuations is accomplished by comparing those values to the Company's swap counterparty valuations. Management believes an adjustment is required to "mid-market" valuations for derivatives tied to its performing loan portfolio to recognize the imprecision and related exposure inherent in the process of estimating expected credit losses as well as velocity of deterioration evident with systemic risks imbedded in these portfolios.



Table of Contents

The following table shows the balance of assets and liabilities at March 31, 2014 and December 31, 2013 measured at fair value on a recurring basis.

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
<b>March 31, 2014</b>				
Assets:				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$ 19,681	\$ 381,709	\$ —	\$ 401,390
U.S. States and political subdivisions securities	—	122,685	4,709	127,394
Mortgage-backed securities — Federal agencies	—	269,520	—	269,520
Corporate debt securities	—	32,140	—	32,140
Foreign government and other securities	—	702	—	702
Total debt securities	19,681	806,756	4,709	831,146
Marketable equity securities	8,451	—	—	8,451
Total investment securities available-for-sale	28,132	806,756	4,709	839,597
Trading account securities	192	—	—	192
Mortgages held for sale	—	10,961	—	10,961
Accrued income and other assets (interest rate swap agreements)	—	9,531	—	9,531
Total	\$ 28,324	\$ 827,248	\$ 4,709	\$ 860,281
Liabilities:				
Accrued expenses and other liabilities (interest rate swap agreements)	\$ —	\$ 9,719	\$ —	\$ 9,719
Total	\$ —	\$ 9,719	\$ —	\$ 9,719
<b>December 31, 2013</b>				
Assets:				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$ 19,631	\$ 375,408	\$ —	\$ 395,039
U.S. States and political subdivisions securities	—	117,741	5,498	123,239
Mortgage-backed securities — Federal agencies	—	275,080	—	275,080
Corporate debt securities	—	31,065	—	31,065
Foreign government and other securities	—	709	—	709
Total debt securities	19,631	800,003	5,498	825,132
Marketable equity securities	7,568	—	—	7,568
Total investment securities available-for-sale	27,199	800,003	5,498	832,700
Trading account securities	192	—	—	192
Mortgages held for sale	—	6,079	—	6,079
Accrued income and other assets (interest rate swap agreements)	—	9,894	—	9,894
Total	\$ 27,391	\$ 815,976	\$ 5,498	\$ 848,865
Liabilities:				
Accrued expenses and other liabilities (interest rate swap agreements)	\$ —	\$ 10,087	\$ —	\$ 10,087
Total	\$ —	\$ 10,087	\$ —	\$ 10,087



Table of Contents

The following table shows changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter ended March 31, 2014 and 2013.

(Dollars in thousands)	U.S. States and political subdivisions securities
Beginning balance January 1, 2014	\$5,498
Total gains or losses (realized/unrealized):	
Included in earnings	—
Included in other comprehensive income	16
Purchases	—
Issuances	—
Sales	—
Settlements	—
Maturities	(805 )
Transfers into Level 3	—
Transfers out of Level 3	—
Ending balance March 31, 2014	\$4,709
Beginning balance January 1, 2013	\$7,701
Total gains or losses (realized/unrealized):	
Included in earnings	—
Included in other comprehensive income	(93 )
Purchases	—
Issuances	—
Sales	—
Settlements	—
Maturities	(538 )
Transfers into Level 3	—
Transfers out of Level 3	—
Ending balance March 31, 2013	\$7,070

There were no gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held at March 31, 2014 or 2013. No transfers between levels occurred during the three months ended March 31, 2014 or 2013.

The following table shows the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a recurring basis at March 31, 2014 and December 31, 2013.

(Dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
March 31, 2014				
Investment securities available-for sale				
Direct placement municipal securities	\$4,709	Discounted cash flows	Credit spread assumption	0.89% - 1.52%
December 31, 2013				

Investment securities available-for sale

Direct placement municipal securities	\$5,498	Discounted cash flows	Credit spread assumption	0.90% - 1.52%
---------------------------------------	---------	-----------------------	--------------------------	---------------

The sensitivity to changes in the unobservable inputs and their impact on the fair value measurement can be significant. The significant unobservable input for direct placement municipal securities is the underlying market level used to determine the fair value measure. An increase (decrease) in the estimated yield level of the market will decrease (increase) the fair value measure of the securities.

## Table of Contents

### Financial Instruments on Non-recurring Basis:

The Company may be required, from time to time, to measure certain other financial assets at fair value on a non-recurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower of cost or market accounting or impairment charges of individual assets.

The Credit Policy Committee (CPC), a management committee, is responsible for overseeing the valuation processes and procedures for Level 3 measurements of impaired loans, other real estate and repossessions. The CPC reviews these assets on a quarterly basis to determine the accuracy of the observable inputs, generally third party appraisals, auction values, values derived from trade publications and data submitted by the borrower, and the appropriateness of the unobservable inputs, generally discounts due to current market conditions and collection issues. The CPC establishes discounts based on asset type and valuation source; deviations from the standard are documented. The discounts are reviewed periodically, annually at a minimum, to determine they remain appropriate. Consideration is given to current trends in market values for the asset categories and gains and losses on sales of similar assets. The Loan and Funds Management Committee of the Board of Directors is responsible for overseeing the CPC.

Discounts vary depending on the nature of the assets and the source of value. Aircraft are generally valued using quarterly trade publications adjusted for engine time, condition, maintenance programs, discounted by 10%. Likewise, autos are valued using current auction values, discounted by 10%; medium and heavy duty trucks are valued using trade publications and auction values, discounted by 15%. Construction equipment and environmental equipment is generally valued using trade publications and auction values, discounted by 20%. Real estate is valued based on appraisals or evaluations, discounted by 20% at a minimum with higher discounts for property in poor condition or property with characteristics which may make it more difficult to market. Commercial loans subject to borrowing base certificates are generally discounted by 20% for receivables and 40% - 75% for inventory with higher discounts when monthly borrowing base certificates are not required or received.

Impaired loans and related write-downs are based on the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are reviewed quarterly and estimated using customized discounting criteria, appraisals and dealer and trade magazine quotes which are used in a market valuation approach. In accordance with fair value measurements, only impaired loans for which a reserve for loan loss has been established based on the fair value collateral require classification in the fair value hierarchy. As a result, only a portion of the Company's impaired loans are classified in the fair value hierarchy.

Partnership investments and the adjustments to fair value primarily result from application of lower of cost or fair value accounting. The partnership investments are priced using financial statements provided by the partnerships. Quantitative unobservable inputs are not reasonably available for reporting purposes.

The Company has established mortgage servicing rights (MSRs) valuation policies and procedures based on industry standards and to ensure valuation methodologies are consistent and verifiable. MSRs and related adjustments to fair value result from application of lower of cost or fair value accounting. For purposes of impairment, MSRs are stratified based on the predominant risk characteristics of the underlying servicing, principally by loan type. The fair value of each tranche of the servicing portfolio is estimated by calculating the present value of estimated future net servicing cash flows, taking into consideration actual and expected mortgage loan prepayment rates, discount rates, servicing costs, and other economic factors. Prepayment rates and discount rates are derived through a third party pricing agent. Changes in the most significant inputs, including prepayment rates and discount rates, are compared to the changes in the fair value measurements and appropriate resolution is made. A fair value analysis is also obtained from an independent third party agent and compared to the internal valuation for reasonableness. MSRs do not trade in an active, open market with readily observable prices and though sales of MSRs do occur, precise terms and conditions typically are not readily available and the characteristics of the Company's servicing portfolio may differ

from those of any servicing portfolios that do trade.

Other real estate is based on the lower of cost or fair value of the underlying collateral less expected selling costs. Collateral values are estimated primarily using appraisals and reflect a market value approach. Fair values are reviewed quarterly and new appraisals are obtained annually. Repossessions are similarly valued.

For assets measured at fair value on a nonrecurring basis the following represents impairment charges (recoveries) recognized on these assets during the quarter ended March 31, 2014: impaired loans \$0.00 million; partnership investments - \$0.03 million; mortgage servicing rights \$0.00 million; repossessions \$0.00 million, and other real estate - \$(0.09) million.

Table of Contents

The following table shows the carrying value of assets at March 31, 2014 and December 31, 2013 measured at fair value on a non-recurring basis.

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
<b>March 31, 2014</b>				
Impaired loans - collateral based	\$—	\$—	\$996	\$996
Accrued income and other assets (partnership investments)	—	—	2,002	2,002
Accrued income and other assets (mortgage servicing rights)	—	—	4,759	4,759
Accrued income and other assets (repossessions)	—	—	7,998	7,998
Accrued income and other assets (other real estate)	—	—	2,892	2,892
<b>Total</b>	<b>\$—</b>	<b>\$—</b>	<b>\$18,647</b>	<b>\$18,647</b>
<b>December 31, 2013</b>				
Impaired loans - collateral based	\$—	\$—	\$670	\$670
Accrued income and other assets (partnership investments)	—	—	2,156	2,156
Accrued income and other assets (mortgage servicing rights)	—	—	4,844	4,844
Accrued income and other assets (repossessions)	—	—	4,262	4,262
Accrued income and other assets (other real estate)	—	—	5,490	5,490
<b>Total</b>	<b>\$—</b>	<b>\$—</b>	<b>\$17,422</b>	<b>\$17,422</b>

The following table below shows the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a non-recurring basis at March 31, 2014 and December 31, 2013.

(Dollars in thousands)	Carrying Value	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
<b>March 31, 2014</b>					
Impaired loans	\$ 996	\$ 996	Collateral based measurements including appraisals, trade publications, and auction values	Discount for lack of marketability and current conditions	20% - 35%
Mortgage servicing rights	4,759	7,868	Discounted cash flows	Constant prepayment rate (CPR) Discount rate	10.6% - 13.4% 9.9% - 13.4%
Repossessions	7,998	8,772	Appraisals, trade publications and auction values	Discount for lack of marketability	0% - 16%
Other real estate	2,892	3,392	Appraisals	Discount for lack of marketability	0% - 73%
<b>December 31, 2013</b>					
Impaired loans	\$ 670	\$ 670	Collateral based measurements including appraisals, trade publications, and auction values	Discount for lack of marketability and current conditions	20% - 35%
Mortgage servicing rights	4,844	8,127	Discounted cash flows	Constant prepayment rate (CPR) Discount rate	9.9% - 11.9% 10.0% - 13.0%

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Repossessions	4,262	4,435	Appraisals, trade publications and auction values	Discount for lack of marketability	0% - 16%
Other real estate	5,490	6,606	Appraisals	Discount for lack of marketability	0% - 48%

GAAP requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring or non-recurring basis.



Table of Contents

The following table shows the fair values of the Company's financial instruments as of March 31, 2014 and December 31, 2013.

(Dollars in thousands)	Carrying or Contract Value	Fair Value	Level 1	Level 2	Level 3
March 31, 2014					
Assets:					
Cash and due from banks	\$ 92,465	\$92,465	\$92,465	\$—	\$—
Federal funds sold and interest bearing deposits with other banks	1,362	1,362	1,362	—	—
Investment securities, available-for-sale	839,597	839,597	28,132	806,756	4,709
Other investments and trading account securities	22,592	22,592	22,592	—	—
Mortgages held for sale	10,961	10,961	—	10,961	—
Loans and leases, net of reserve for loan and lease losses	3,492,558	3,501,164	—	—	3,501,164
Cash surrender value of life insurance policies	59,045	59,045	59,045	—	—
Mortgage servicing rights	4,759	7,868	—	—	7,868
Interest rate swaps	9,531	9,531	—	9,531	—
Liabilities:					
Deposits	\$ 3,708,423	\$3,711,388	\$2,716,638	\$994,750	\$—
Short-term borrowings	297,647	297,647	172,366	125,281	—
Long-term debt and mandatorily redeemable securities	59,555	58,324	—	58,324	—
Subordinated notes	58,764	69,706	—	69,706	—
Interest rate swaps	9,719	9,719	—	9,719	—
Off-balance-sheet instruments *	—	178	—	178	—
December 31, 2013					
Assets:					
Cash and due from banks	\$ 77,568	\$77,568	\$77,568	\$—	\$—
Federal funds sold and interest bearing deposits with other banks	2,484	2,484	2,484	—	—
Investment securities, available-for-sale	832,700	832,700	27,199	800,003	5,498
Other investments and trading account securities	22,592	22,592	22,592	—	—
Mortgages held for sale	6,079	6,079	—	6,079	—
Loans and leases, net of reserve for loan and lease losses	3,465,819	3,491,718	—	—	3,491,718
Cash surrender value of life insurance policies	58,558	58,558	58,558	—	—
Mortgage servicing rights	4,844	8,127	—	—	8,127
Interest rate swaps	9,894	9,894	—	9,894	—
Liabilities:					
Deposits	\$ 3,653,650	\$3,657,586	\$2,722,804	\$934,782	\$—
Short-term borrowings	314,131	314,131	184,304	129,827	—
Long-term debt and mandatorily redeemable securities	58,335	56,896	—	56,896	—
Subordinated notes	58,764	62,602	—	62,602	—
Interest rate swaps	10,087	10,087	—	10,087	—

Off-balance-sheet instruments *	—	177	—	177	—
---------------------------------	---	-----	---	-----	---

\* Represents estimated cash outflows required to currently settle the obligations at current market rates.

The methodologies for estimating fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are discussed above. The estimated fair value approximates carrying value for cash and due from banks, federal funds sold and interest bearing deposits with other banks, other investments, and cash surrender value of life insurance policies. The methodologies for other financial assets and financial liabilities are discussed below:

Loans and Leases — For variable rate loans and leases that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values of other loans and leases are estimated using discounted cash flow analyses which use interest rates currently being offered for loans and leases with similar terms to borrowers of similar credit quality.

Deposits — The fair values for all deposits other than time deposits are equal to the amounts payable on demand (the carrying value). Fair values of variable rate time deposits are equal to their carrying values. Fair values for fixed rate time deposits are estimated using discounted cash flow analyses using interest rates currently being offered for deposits with similar remaining maturities.

Table of Contents

Short-Term Borrowings — The carrying values of Federal funds purchased, securities sold under repurchase agreements, and other short-term borrowings, including the liability related to mortgage loans available for repurchase under GNMA optional repurchase programs, approximate their fair values.

Long-Term Debt and Mandatorily Redeemable Securities — The fair values of long-term debt are estimated using discounted cash flow analyses, based on the current estimated incremental borrowing rates for similar types of borrowing arrangements. The carrying values of mandatorily redeemable securities are based on the current estimated cost of redeeming these securities which approximate their fair values.

Subordinated Notes — Fair values are estimated based on calculated market prices of comparable securities.

Off-Balance-Sheet Instruments — Contract and fair values for certain off-balance-sheet financial instruments (guarantees) are estimated based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

Limitations — Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instruments. Because no market exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other such factors.

These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. These estimates are subjective in nature and require considerable judgment to interpret market data. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange, nor are they intended to represent the fair value of the Company as a whole. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The fair value estimates presented herein are based on pertinent information available to management as of the respective balance sheet date. Although the Company is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein.

Other significant assets, such as premises and equipment, other assets, and liabilities not defined as financial instruments, are not included in the above disclosures. Also, the fair value estimates for deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market.

Table of Contents

## ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following management's discussion and analysis is presented to provide information concerning 1st Source Corporation and its subsidiaries' (collectively referred to as "the Company", "we", and "our") financial condition as of March 31, 2014, as compared to December 31, 2013, and the results of operations for the three months ended March 31, 2014 and 2013. This discussion and analysis should be read in conjunction with our consolidated financial statements and the financial and statistical data appearing elsewhere in this report and our 2013 Annual Report.

Except for historical information contained herein, the matters discussed in this document express "forward-looking statements." Generally, the words "believe," "contemplate," "seek," "plan," "possible," "assume," "expect," "intend," "targeted," "remain," "estimate," "anticipate," "project," "will," "should," "indicate," "would," "may" and other similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. Those statements, including statements, projections, estimates or assumptions concerning future events or performance, and other statements that are other than statements of historical fact, are subject to material risks and uncertainties. We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made. We may make other written or oral forward-looking statements from time to time. Readers are advised that various important factors could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected in such forward-looking statements. Such factors include, but are not limited to, changes in law, regulations or GAAP; our competitive position within the markets we serve; increasing consolidation within the banking industry; unforeseen changes in interest rates; unforeseen changes in loan prepayment assumptions; unforeseen downturns in or major events affecting the local, regional or national economies or the industries in which we have credit concentrations; and other matters discussed in our filings with the SEC, including our Annual Report on Form 10-K for 2013, which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

## FINANCIAL CONDITION

Our total assets at March 31, 2014 were \$4.77 billion, an increase of \$50.37 million or 1.07% from December 31, 2013. Total loans and leases were \$3.58 billion, an increase of \$28.24 million or 0.80% from December 31, 2013. Total investment securities, available for sale were \$839.60 million which represented an increase of \$6.90 million or 0.83% and total deposits were \$3.71 billion, an increase of \$54.77 million or 1.50% over the comparable figures at the end of 2013. Short-term borrowings were \$297.65 million, a decrease of \$16.48 million or 5.25% from December 31, 2013.

Nonperforming assets at March 31, 2014 were \$35.88 million, a decrease of \$10.87 million or 23.25% from the \$46.75 million reported at December 31, 2013. At March 31, 2014 and December 31, 2013, nonperforming assets were 0.98% and 1.29%, respectively of net loans and leases.

The following table shows accrued income and other assets.

(Dollars in thousands)	March 31, 2014	December 31, 2013
Accrued income and other assets:		
Bank owned life insurance cash surrender value	\$59,045	\$58,558
Accrued interest receivable	13,251	12,537
Mortgage servicing assets	4,759	4,844

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Other real estate	2,091	4,539
Former bank premises held for sale	801	951
Repossessions	7,998	4,262
All other assets	35,332	35,953
Total accrued income and other assets	\$123,277	\$121,644

29

---

Table of Contents

## CAPITAL

As of March 31, 2014, total shareholders' equity was \$596.59 million, up \$11.21 million or 1.91% from the \$585.38 million at December 31, 2013. In addition to net income of \$13.63 million, other significant changes in shareholders' equity during the first three months of 2014 included \$4.17 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$8.49 million at March 31, 2014, compared to \$6.58 million at December 31, 2013. The increase in accumulated other comprehensive income/(loss) during 2014 was the result of changes in unrealized gain/(loss) on securities in the available-for-sale portfolio. Our equity-to-assets ratio was 12.50% as of March 31, 2014, compared to 12.39% at December 31, 2013. Book value per common share rose to \$24.51 at March 31, 2014, from \$24.07 at December 31, 2013.

We declared and paid dividends per common share of \$0.17 during the first quarter of 2014. The trailing four quarters dividend payout ratio, representing dividends per common share divided by diluted earnings per common share, was 32.54%. The dividend payout is continually reviewed by management and the Board of Directors subject to the Company's capital and dividend policy.

The banking regulators have established guidelines for leverage capital requirements, expressed in terms of Tier 1 or core capital as a percentage of average assets, to measure the soundness of a financial institution. In addition, banking regulators have established risk-based capital guidelines for U.S. banking organizations. The actual capital amounts and ratios of 1st Source Corporation and 1st Source Bank as of March 31, 2014, are presented in the table below:

(Dollars in thousands)	Actual		Minimum Capital Adequacy		To Be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio	Amount	Ratio	Amount	Ratio	
Total Capital (to Risk-Weighted Assets):							
1st Source Corporation	\$610,346	15.94	% \$306,341	8.00	% \$382,926	10.00	%
1st Source Bank	574,349	15.03	305,711	8.00	382,139	10.00	
Tier 1 Capital (to Risk-Weighted Assets):							
1st Source Corporation	559,038	14.60	153,171	4.00	229,756	6.00	
1st Source Bank	525,150	13.74	152,856	4.00	229,283	6.00	
Tier 1 Capital (to Average Assets):							
1st Source Corporation	559,038	12.15	184,067	4.00	230,084	5.00	
1st Source Bank	525,150	11.43	183,814	4.00	229,768	5.00	

## LIQUIDITY AND INTEREST RATE SENSITIVITY

Effective liquidity management ensures that the cash flow requirements of depositors and borrowers, as well as our operating cash needs are met. Funds are available from a number of sources, including the securities portfolio, the core deposit base, Federal Home Loan Bank (FHLB) borrowings, Federal Reserve Bank (FRB) borrowings, and the capability to package loans for sale.

We have borrowing sources available to supplement deposits and meet our funding needs. 1st Source Bank has established relationships with several banks to provide short term borrowings in the form of federal funds purchased. At March 31, 2014, we had \$44.00 million outstanding and could borrow approximately \$221.00 million for a short time from these banks on a collective basis. As of March 31, 2014, we had \$147.39 million outstanding in FHLB advances and could borrow an additional \$60.13 million. We also had \$385.90 million available to borrow from the

FRB with no amounts outstanding as of March 31, 2014.

Our loan to asset ratio was 74.95% at March 31, 2014 compared to 75.15% at December 31, 2013 and 74.01% at March 31, 2013. Cash and cash equivalents totaled \$93.83 million at March 31, 2014 compared to \$80.05 million at December 31, 2013 and \$64.46 million at March 31, 2013. At March 31, 2014, the Statement of Financial Condition was rate sensitive by \$139.74 million more assets than liabilities scheduled to reprice within one year, or approximately 1.07%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs.

Under Indiana law governing the collateralization of public fund deposits, the Indiana Board of Depositories determines which financial institutions are required to pledge collateral based on the strength of their financial ratings. We have been informed that no collateral is required for our public fund deposits. However, the Board of Depositories could alter this requirement in the future and adversely impact our liquidity. Our potential liquidity exposure if we must pledge collateral is approximately \$536 million.

Table of Contents

RESULTS OF OPERATIONS

Net income for the three month period ended March 31, 2014 was \$13.63 million, compared to \$12.40 million for the same period in 2013. Diluted net income per common share was \$0.55 for the three month period ended March 31, 2014, compared to \$0.50 for the same period in 2013. Return on average common shareholders' equity was 9.30% for the three months ended March 31, 2014, compared to 8.90% in 2013. The return on total average assets was 1.18% for the three months ended March 31, 2014, compared to 1.11% in 2013.

The increase in net income for the three months ended March 31, 2014, over the first three months of 2013, was primarily the result of an increase in net interest income and a decrease in noninterest expense. Details of the changes in the various components of net income are discussed further below.

NET INTEREST INCOME

The taxable equivalent net interest income for the three months ended March 31, 2014 was \$39.09 million, an increase of 2.27% over the same period in 2013. The net interest margin on a fully taxable equivalent basis was 3.59% for the three months ended March 31, 2014, compared to 3.64% for the three months ended March 31, 2013.

During the three month period ended March 31, 2014, average earning assets increased \$151.99 million or 3.57% over the comparable period in 2013. Average interest-bearing liabilities increased \$76.86 million or 2.35% for the three month period ended March 31, 2014 over the comparable period one year ago. The yield on average earning assets decreased 19 basis points to 4.03% for the first quarter of 2014 from 4.22% for the first quarter of 2013. The rate earned on assets decreased due to the reduction in loan and investment yields in the current interest rate environment. Total cost of average interest-bearing liabilities decreased 18 basis points to 0.58% for the first quarter 2014 from 0.76% for the first quarter 2013. The result to the net interest margin, or the ratio of net interest income to average earning assets, was a decrease of 5 basis points for the three month period ended March 31, 2014 from March 31, 2013.

The largest contributor to the decrease in the yield on average earning assets for the three months ended March 31, 2014, compared to the three months ended March 31, 2013, was a reduction in yields on net loans and leases of 31 basis points. Average net loans and leases increased \$201.19 million or 6.02% for the first quarter of 2014 from the first quarter of 2013. Total average investment securities decreased \$25.45 million or 2.97% for the first quarter over one year ago. Tax equivalent yield on investment securities decreased 7 basis points for the first quarter 2014. Average mortgages held for sale decreased \$3.06 million or 35.44% for the three month period ended March 31, 2014, over the comparable period a year ago. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances, Federal Reserve Bank and Federal Home Loan Bank stock and commercial paper, decreased \$20.68 million or 37.83% for the three month period ended March 31, 2014, over the comparable period a year ago.

Average interest-bearing deposits decreased \$58.30 million or 1.93% for the first quarter of 2014 over the same period in 2013. The effective rate paid on average interest-bearing deposits decreased 20 basis points to 0.41% for the first quarter 2014 compared to 0.61% for the first quarter 2013. The decline in the average cost of interest-bearing deposits during the first quarter of 2014 as compared to the first quarter of 2013 was primarily the result of interest rate re-pricing on maturing certificates of deposit and a change in deposit mix.

Average short-term borrowings increased \$148.55 million or 124.44% for the first quarter of 2014 compared to the same period in 2013 in order to fund loan growth. Interest paid on short-term borrowings increased 10 basis points for the first quarter of 2014. Average long-term debt decreased \$13.39 million or 18.62% during the first quarter of 2014 as compared to the first quarter of 2013. The decrease in long-term borrowings during the first quarter of 2014 as



compared to the first quarter of 2013 was the result of decreased borrowings with the Federal Home Loan Bank (FHLB). Interest paid on long-term borrowings increased 119 basis points for the first quarter of 2014 compared to the first quarter of 2013 due to higher rates on mandatorily redeemable securities, offset by lower effective rates on FHLB borrowings.

Table of Contents

The following table provides an analysis of net interest income and illustrates the interest income earned and interest expense charged for each major component of interest earning assets and interest bearing liabilities. Yields/rates are computed on a tax-equivalent basis, using a 35% rate. Nonaccrual loans and leases are included in the average loan and lease balance outstanding.

**DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY  
INTEREST RATES AND INTEREST DIFFERENTIAL**

(Dollars in thousands)	Three Months Ended March 31, 2014			2013				
	Average Balance	Interest Income/Expense	Yield/ Rate	Average Balance	Interest Income/Expense	Yield/ Rate		
<b>ASSETS</b>								
Investment securities:								
Taxable	\$706,115	\$ 3,345	1.92 %	\$754,029	\$ 3,695	1.99 %		
Tax exempt	125,483	1,213	3.92 %	103,022	1,137	4.48 %		
Mortgages held for sale	5,578	70	5.09 %	8,638	71	3.33 %		
Net loans and leases	3,543,219	38,919	4.45 %	3,342,033	39,199	4.76 %		
Other investments	33,995	277	3.30 %	54,678	242	1.79 %		
<b>Total earning assets</b>	<b>4,414,390</b>	<b>43,824</b>	<b>4.03 %</b>	<b>4,262,400</b>	<b>44,344</b>	<b>4.22 %</b>		
Cash and due from banks	58,069			56,700				
Reserve for loan and lease losses	(84,268 )			(84,134 )				
Other assets	309,976			308,313				
<b>Total assets</b>	<b>\$4,698,167</b>			<b>\$4,543,279</b>				
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>								
Interest-bearing deposits	\$2,955,755	\$ 2,971	0.41 %	\$3,014,056	\$ 4,542	0.61 %		
Short-term borrowings	267,919	136	0.21 %	119,373	32	0.11 %		
Subordinated notes	58,764	1,055	7.28 %	58,764	1,055	7.28 %		
Long-term debt and mandatorily redeemable securities	58,519	575	3.98 %	71,907	495	2.79 %		
<b>Total interest bearing liabilities</b>	<b>3,340,957</b>	<b>4,737</b>	<b>0.58 %</b>	<b>3,264,100</b>	<b>6,124</b>	<b>0.76 %</b>		
Noninterest-bearing deposits	714,200			650,217				
Other liabilities	48,323			63,440				
Shareholders' equity	594,687			565,522				
<b>Total liabilities and shareholders' equity</b>	<b>\$4,698,167</b>			<b>\$4,543,279</b>				
<b>Net interest income</b>		<b>\$ 39,087</b>			<b>\$ 38,220</b>			
<b>Net interest margin on a tax equivalent basis</b>			<b>3.59 %</b>			<b>3.64 %</b>		

PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES

The provision for loan and lease losses for the three month period ended March 31, 2014 was \$0.80 million compared to a provision for loan and lease losses in the three month period ended March 31, 2013 of \$0.76 million. Net recoveries of \$0.70 million were recorded for the first quarter 2014, compared to net charge-offs of \$0.06 million for the same quarter a year ago.

On March 31, 2014, 30 day and over loan and lease delinquencies were 0.37% compared to 0.13% on March 31, 2013. The increase in delinquencies occurred primarily in the aircraft portfolio. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.38% as compared to 2.49% one year ago. A summary of loan and lease loss experience during the three months ended March 31, 2014 and 2013 is located in Note 5 of the Consolidated Financial Statements.

A loan or lease is considered impaired, based on current information and events, if it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan or lease agreement. We evaluate loans and leases exceeding \$100,000 for impairment and establish a specific reserve as a component of the reserve for loan and lease losses when it is probable all amounts due will not be collected pursuant to the contractual terms of the loan or lease and the recorded investment in the loan or lease exceeds its fair value. A summary of impaired loans as of March 31, 2014 and December 31, 2013 is reflected in Note 4 of the Consolidated Financial Statements.

Table of Contents

## NONPERFORMING ASSETS

The following table shows nonperforming assets.

(Dollars in thousands)	March 31, 2014	December 31, 2013	March 31, 2013
Loans and leases past due 90 days or more	\$307	\$287	\$231
Nonaccrual loans and leases	24,680	36,707	42,776
Other real estate	2,091	4,539	4,372
Former bank premises held for sale	801	951	951
Repossessions	7,998	4,262	103
Total nonperforming assets	\$35,877	\$46,746	\$48,433

Nonperforming assets as a percentage of total loans and leases were 0.98% at March 31, 2014, 1.29% at December 31, 2013, and 1.41% at March 31, 2013. Nonperforming assets totaled \$35.88 million at March 31, 2014, a decrease of 23.25% from the \$46.75 million reported at December 31, 2013, and a 25.92% decrease from the \$48.43 million reported at March 31, 2013. The decrease during the first three months of 2014 compared to the same period in 2013 was primarily related to a decrease in nonaccrual loans and leases and the sale of other real estate as the economy slowly improves.

The decrease in nonaccrual loans and leases at March 31, 2014 from December 31, 2013 occurred primarily in the aircraft, auto and light truck and commercial real estate portfolios. The decrease in nonaccrual loans and leases at March 31, 2014 from March 31, 2013 occurred primarily in the aircraft, commercial real estate and construction equipment financing portfolios offset by an increase the commercial portfolio. A summary of nonaccrual loans and leases and past due aging for the period ended March 31, 2014 and December 31, 2013 is located in Note 4 of the Consolidated Financial Statements.

Other real estate is the result of foreclosing on real estate in the local market for which we have a current appraisal and are well secured. Other real estate decreased over the past year due to current sales of existing properties outpacing current foreclosures.

Repossessions consisted mainly of aircraft financing at March 31, 2014. At the time of repossession, the recorded amount of the loan or lease is written down to the fair value of the equipment or vehicle by a charge to the reserve for loan and lease losses or other income, if a positive adjustment, unless the equipment is in the process of immediate sale. Any subsequent fair value write-downs or write-ups, to the extent of previous write-downs, are included in noninterest expense.

The following table shows a summary of other real estate and repossessions.

(Dollars in thousands)	March 31, 2014	December 31, 2013	March 31, 2013
Commercial and agricultural loans	\$—	\$23	\$—
Auto and light truck	93	145	5
Medium and heavy duty truck	—	—	78
Aircraft financing	7,892	4,082	—
Construction equipment financing	—	—	—
Commercial real estate	1,145	3,101	3,236
Residential real estate	659	959	717
Consumer loans	300	491	439

Total	\$10,089	\$8,801	\$4,475
-------	----------	---------	---------

For financial statement purposes, nonaccrual loans and leases are included in loan and lease outstandings, whereas repossessions and other real estate are included in other assets.

Foreign Outstandings — Our foreign loan and lease outstandings, all denominated in U.S. dollars except for one loan denominated in Euros, which was not significant, were \$248.12 million and \$270.30 million as of March 31, 2014 and December 31, 2013, respectively. Foreign loans and leases are in aircraft financing. Loan and lease outstandings to borrowers in Brazil and Mexico were \$127.26 million and \$79.18 million as of March 31, 2014, respectively, compared to \$142.79 million and \$77.96 million as of December 31, 2013, respectively. Outstanding balances to borrowers in other countries were insignificant.

Table of Contents

## NONINTEREST INCOME

Noninterest income for the three month period ended March 31, 2014 and 2013 was \$19.40 million and \$18.95 million, respectively. The following table shows the details of noninterest income.

(Dollars in thousands)	Three Months Ended	
	March 31,	
	2014	2013
Noninterest income:		
Trust fees	\$4,476	\$4,101
Service charges on deposit accounts	2,066	2,239
Debit card income	2,232	2,065
Mortgage banking income	1,334	1,628
Insurance commissions	1,563	1,446
Equipment rental income	4,082	4,012
Gains on investment securities available-for-sale	963	—
Other income	2,682	3,457
Total noninterest income	\$19,398	\$18,948

Noninterest income increased \$0.45 million or 2.37% for the three months ended March 31, 2014 as compared to the same period in 2013. Insurance commissions and equipment rental income increased slightly during the first quarter of 2014 over the same period in 2013.

Trust fees increased \$0.38 million or 9.14% for the three months ended March 31, 2014 over the same period a year ago. The increase in trust fees was primarily the result of an increase in market values of investments held in the trust accounts of clients.

Service charges on deposit accounts decreased \$0.17 million or 7.73% for the three months ended March 31, 2014 over the comparable period one year ago. The decrease in service charges on deposit accounts reflects a lower volume of nonsufficient fund transactions.

Debit card income increased \$0.17 million or 8.09% in the three months ended March 31, 2014 over the same period a year ago. The increase in debit card income was the result of an increased volume of debit card transactions in 2014 and a higher fee structure that went into effect at the end of the first quarter of 2013.

Mortgage banking income decreased \$0.29 million or 18.06% in the first quarter of 2014 as compared to the first quarter of 2013. This variance was caused by decreased gains on loan sales due to lower production volumes offset by lower mortgage servicing rights amortization expense in 2014.

Gains on investment securities available-for-sale increased \$0.96 million in the first quarter of 2014 compared to the first quarter 2013 due to the partial sale of a marketable equity security.

Other income decreased \$0.78 million or 22.42% for the three months ended March 31, 2014 over the same period a year ago. The decrease was primarily the result of a loss on a partnership investment in first quarter 2014.

Table of Contents

## NONINTEREST EXPENSE

Noninterest expense for the three month period ended March 31, 2014 and 2013 was \$35.97 million and \$36.55 million, respectively. The following table shows the details of noninterest expense.

(Dollars in thousands)	Three Months Ended March 31,	
	2014	2013
Noninterest expense:		
Salaries and employee benefits	\$19,482	\$19,936
Net occupancy expense	2,437	2,207
Furniture and equipment expense	4,237	3,899
Depreciation - leased equipment	3,249	3,225
Professional fees	1,128	1,355
Supplies and communication	1,392	1,536
FDIC and other insurance	864	878
Business development and marketing expense	1,684	773
Loan and lease collection and repossession expense	(494)	) 757
Other expense	1,994	1,984
Total noninterest expense	\$35,973	\$36,550

Noninterest expense decreased \$0.58 million or 1.58% for the first quarter 2014 as compared to the same period in 2013. Depreciation on leased equipment and other expense increased slightly in 2014 over the same period in 2013. Supplies and communication expense and FDIC and other insurance expense decreased slightly during the first quarter of 2014 over the same period in 2013.

Salaries and employee benefits decreased \$0.45 million or 2.28% in the three months ended March 31, 2014 versus the three months ended March 31, 2013. Lower base salary expense was primarily due to fewer full time equivalent employees offset by higher executive incentives. Loan producer commissions were lower due to decreased residential mortgage loan volumes.

Net occupancy expense was higher by \$0.23 million or 10.42% for the first quarter of 2014 compared to the same period one year ago. The increase was primarily a result of higher snow removal services.

Furniture and equipment expense increased \$0.34 million or 8.67% for the first quarter 2014 compared to the same period in 2013. Furniture and equipment expense was higher mainly due to increased computer processing charges and software maintenance costs offset by decreased equipment rental.

Professional fees decreased \$0.23 million or 16.75% for the three month period ended March 31, 2014 as compared to the three month period ended March 31, 2013. The decrease in professional fees in 2014 was primarily the result of reduced utilization of consulting services.

Business development and marketing expense increased \$0.91 million or 117.85% for the three months ended March 31, 2014 versus the three months ended March 31, 2013. The first quarter increase was due to higher charitable contributions.

Loan and lease collection and repossession expense decreased \$1.25 million or 165.26% for the three months ended March 31, 2014 compared to the same period in 2013 primarily due to gains on the sale of other real estate owned and repossessions and lower repurchased mortgage loan losses in 2014 compared to 2013.

## INCOME TAXES

The provision for income taxes for the three month period ended March 31, 2014 was \$7.61 million compared to \$6.99 million for the same period in 2013. The effective tax rates were 35.82% and 36.05% for the first quarter ended March 31, 2014 and 2013, respectively.

Effective January 1, 2014, the Indiana Financial Institutions (IFI) tax rate decreased from 8.5% to 8.0% and will continue to decrease by 0.5% each of the next three years. As a result of the rate change, we decreased the carrying value of certain state deferred tax assets. The impact of this change was not material and was recorded in the financial statements during the second quarter of 2013. Additionally, on March 26, 2014 the IFI tax rate decreases from 6.5% in 2018 to 4.9% in 2023. These further decreases did not have an impact on our deferred taxes and as a result, no amount was recorded in our financial statements for this rate change.



Table of Contents

ITEM 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in market risks faced by 1st Source since December 31, 2013. For information regarding our market risk, refer to 1st Source’s Annual Report on Form 10-K for the year ended December 31, 2013.

ITEM 4.

CONTROLS AND PROCEDURES

As of the end of the period covered by this report an evaluation was carried out, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, at March 31, 2014, our disclosure controls and procedures were effective in ensuring that information required to be disclosed by 1st Source in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and are designed to ensure that information required to be disclosed in those reports is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure.

In addition, there were no changes in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the first fiscal quarter of 2014 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings.

1st Source and its subsidiaries are involved in various legal proceedings incidental to the conduct of our businesses. Management does not expect that the outcome of any such proceedings will have a material adverse effect on our consolidated financial position or results of operations.

ITEM 1A. Risk Factors.

There have been no material changes in risks faced by 1st Source since December 31, 2013. For information regarding our risk factors, refer to 1st Source’s Annual Report on Form 10-K for the year ended December 31, 2013.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs*	Maximum Number (or Approximate Dollar Value) of Shares that may yet be Purchased Under the Plans or Programs
--------	----------------------------------	------------------------------	---	--

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

January 01 - 31, 2014	—	\$—	—	879,968
February 01 - 28, 2014	48,607	28.81	48,607	831,361
March 01 - 31, 2014	—	—	—	831,361

\* 1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on April 26, 2007. Under the terms of the plan, 1st Source may repurchase up to 2,000,000 shares of its common stock when favorable conditions exist on the open market or through private transactions at various prices from time to time. Since the inception of the plan, 1st Source has repurchased a total of 1,168,639 shares.

ITEM 3. Defaults Upon Senior Securities.

None

Table of Contents

ITEM 4. Mine Safety Disclosures.

None

ITEM 5. Other Information.

None

ITEM 6. Exhibits

The following exhibits are filed with this report:

- 31.1 Certification of Chief Executive Officer required by Rule 13a-14(a).
- 31.2 Certification of Chief Financial Officer required by Rule 13a-14(a).
- 32.1 Certification pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer.
- 32.2 Certification pursuant to 18 U.S.C. Section 1350 of Chief Financial Officer.
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.LAB XBRL Taxonomy Extension Labels Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

1st Source Corporation

DATE April 24, 2014

/s/ CHRISTOPHER J. MURPHY III  
Christopher J. Murphy III  
Chairman of the Board, President and CEO

DATE April 24, 2014

/s/ ANDREA G. SHORT  
Andrea G. Short  
Treasurer and Chief Financial Officer  
Principal Accounting Officer